Tab I-4, Outline and Issues Related to a Separate Exposure Draft Dealing with Actuarial Issues

At the March meeting the Board discussed a standard-setting project that would require the gains and losses from changes in assumptions to be displayed separately on the statement of net costs. A separate display would allow users of financial statements to see the basic programmatic cost trends separate and distinct from the effect of changes in assumptions.

The Board discussed the advantages of establishing a separate track for such a standard apart from social insurance. A separate track would have several advantages. First, it would facilitate respondents' comments. Some respondents will focus so heavily on social insurance that the issue of display of changes in assumptions and other actuarial issues would be a minor point. Also, a separate track would avoid encumbering the actuarial standard with social insurance issues, especially if more time is needed for the latter. Since there was no objection to the suggestion of a separate standard the staff has developed this outline.

The actuarial issues ED will afford an opportunity to address three other issues in addition to financial statement display. They involve guidance for selecting (1) assumptions, in general; (2) the discount rate; and (3) the valuation date. These issues arise in current standards, especially the sections of SFFAS 5, Accounting for Liabilities of the Federal Government*, dealing with pension, other retirement benefits (ORB), and other post-employment benefits (OPEB); and, of course, SFFAS 17.*

The following outline for an exposure draft of a standard is currently titled "financial accounting and reporting long-range estimates." This title is "under development" and could change. The title should capture the notion that the standard deals with actuarial issues with respect to long-range estimates. Most long-range estimates involve actuarial issues. They require the selection of assumptions, including the discount rate, and a valuation date; and also the issue of how to display actuarial gains and losses.

The outline below contains an explanation and four staff questions for the Board's consideration. With the Board's approval the staff will proceed from the outline to a first draft of a standard.

Outline for Standard on
Financial Accounting and Reporting Using Long-Range Estimates

1. Mr. Mosso's letter to the head of agencies

2. Executive Summary

    a. What is the Board proposing?
    b. Why is the Board making this proposal?
    c. How does this proposal improve Federal financial reporting?
    d. How does this proposal contribute to meeting Federal financial reporting objectives?

3. Questions for Respondents

4. Introduction

    a. Purpose
    b. Scope

c. Background

…The largest items on the operating statement for the Financial Report of the United States Government and on the SNC for the component entities involved are the changes in actuarial estimates. …

d. Materiality
e. Effective Date

5. Proposed standard

a. Criteria for selecting assumptions –

Question #1: Does the Board agree that guidance for selecting assumptions needs to be addressed in the ED? If so, does the Board agree that the four sub-paragraphs immediately below represent the framework such guidance?

In its guidance in SFFAS 5, *Accounting for Liabilities of the Federal Government*, and SFFAS 17, *Accounting for Social Insurance*, and the new social insurance exposure draft the Board has provided very general guidance with respect to selecting assumptions for present valuations. The new project will afford an opportunity for the Board to re-affirm – or change – past guidance. The staff proposes that the guidance continue to be general rather than require specific assumptions or parameters and to emphasize long-term trends. For example, the following is based on current FASAB standards for pensions and other post-employment benefits and the new social insurance ED:

i. The present values used for liability and expense estimates shall be based on the entity's best estimates of demographic and economic assumptions, taking each factor individually and incorporating future changes mandated by current law.

ii. Economic assumptions shall be based on the actual past experience of the covered group but shall emphasize expected long-term future trends rather than give undue weight to recent past experience. The actuarial assumptions shall also take into account relevant factors that may make the future materially different than past experience.

iii. Although emphasis shall be given to the combined effect of all assumptions, the reasonableness of each actuarial assumption shall be considered independently on the basis of its own merits and its consistency with each other assumption.

iv. The selection of all actuarial assumptions shall be guided by Actuarial Standards of Practice,[1] as revised from time to time by the Actuarial Standards Board.

[1] See Actuarial Standards of Practice No. 32, *Social Insurance*, No. 4, *Measuring Pension Obligations*, especially paragraph 3.4, Actuarial assumptions, and No. 27, *Selection of Economic Assumptions for Measuring Pension Obligation.*

b. Discount Rate –

Question #2: Does the Board agree that the discount rate needs to be addressed in the ED?

The social insurance ED does not address the discount rate per se. Its general guidance for selecting economic assumptions would apply to the discount rate. Accordingly, the rate used would be within the entity's best-estimate range of anticipated experience taking into account past experience and reasonable expectations. Further, it would reflect relevant measurement-specific factors and be consistent with every other economic assumption selected by the actuary for the measurement.[2]

The employee pension and other retirement benefits standards provide general guidance regarding selecting long-range assumptions (SFFAS 5, pars. 65 and 83) but, with respect to the discount rate, gives the example of the long-term federal government borrowing rate (SFFAS 5, pars. 66 and 83). The post-employment benefits (OPEB) standard (SFFAS 5, par. 95) is slightly different. It requires employer entities to estimate the amount and timing of future payments using the Treasury borrowing rate for securities of similar maturity to the period over which the payments are to be made.

The Department of Veterans Affairs (DVA) has raised an issue regarding the discount rate (see Appendix A, "DVA Letter and FASAB Staff Response"). As required by SFFAS 5, the DVA calculates the future veterans' compensation liability using as the discount rate a Treasury borrowing rate. The questions for DVA have been which Treasury rate and over what period. Possibilities include the rates on the 30-year bond, the 10-year bond, various Treasury rates based on the year the payment is to be made, or some average thereof.

The DVA currently uses a US Treasury rate for securities maturing in the year the benefit payment projected to be made. As a result, the future liabilities projection is susceptible to more volatility than alternative discounting measures. The DVA has been criticized for the extreme changes in the future liabilities projection as a result of using the spot rate.

DVA suggests the following alternatives that it believes would provide a more soundly-based representation of the long-term interest rates while at the same time decreasing the volatility of interest rates compared with its current practice of using discount rates based on observed values from the capital markets as of a single day rate.

- An average yield curve over a specified period of time, such as the prior one month, quarter, five years or longer. This would tend to stabilize the estimate, as daily fluctuations would not have as significant of an effect as that of a

[2] See Actuarial Standards of Practice No. 4, *Measuring Pension Obligations*, especially paragraph **5.2.4**, Actuarial Assumptions; No. 27, *Selection of Economic Assumptions for Measuring Pension Obligation*; and No. 32, *Social Insurance*.

single day.

- Estimated long-term average interest rates, possibly using historical averages over a long period, at least over an entire business cycle.

- Longer-term interest rate expectations reflecting actuarial judgment in assigning discount rates, as currently used by the Social Security and Medicare Statement of Social Insurance and many private pension plans.

Discount rate issues include whether the rate specified would represent the Government's long-range cost of borrowing, i.e., if the 30-year bond represents only 1% of Treasury's outstanding securities, is that representative? Other options include an average of Treasury rates for each year, as VA is doing. Averaging raises the issue of smoothing, i.e., averaging smoothes the effect of interest rate fluctuations.

c. Valuation date –

Question #3: Does the Board agree that the valuation date needs to be addressed in the ED? If so, does the Board agree that the valuation date should be the same as in current FASAB standards, i.e., "a date as close to the end of the fiscal year being reported upon as possible and no more than one year prior to the end of the current year"?

The ED would also address the selection of the valuation date for actuarial calculations. The social insurance ED essentially follows SFFAS 17 with respect to the valuation date, with the addition of the phrase "with projections to the end of the fiscal year taking into account major factors that affect the results that are known at the time of the projection." The projection could entail additional work for entities not currently doing so. The Office of Personnel Management does project their amounts to the end of the fiscal year.

The social insurance ED paragraph is as follows:

> All projections and estimates required in these standards shall be made as of a date (the valuation date) as close to the end of the fiscal year being reported upon ("current year") as possible and no more than one year prior to the end of the current year, with projections to the end of the fiscal year taking into account major factors that affect the results that are known at the time of the projection.. This valuation date should be consistently followed from year to year. [par. 26]

Citing the SFFAS17 paragraph, the Board noted in SFFAS 25, *Reclassification of Stewardship Responsibilities and Eliminating the Current Services Assessment*, that the impact of the change in audit status for the SOSI should be mitigated by the fact that much of the actuarial and audit work can be done before the end of the fiscal year. The Board noted that SFFAS 17 thus provides considerable

flexibility in selecting the measurement date.[3] The sections of SFFAS 5 dealing with pensions and other employee retirement benefits and OPEB do not address the valuation date per se.

In the first phase of its postretirement benefit obligation project the Financial Accounting Standards Board (FASB) addressed valuation date. It decided to require entities to report the over-funded or under-funded status measured as of the date of the financial statements and eliminate the option in Statements 87 and 106 that permits plan assets and obligations to be measured as of a date not more than three months prior to the balance sheet.

d. Display –

Question #4: Does the Board agree that display requirements for all Government entities with actuarial applications needs to be addressed in the ED? If so, does the Board agree that the display should be as described below?

The issue of display is, of course, the initial reason for undertaking new guidance. The ED would address the display of gains and losses on statement of net cost and the liability on the balance sheet. During its consideration of the social insurance ED the Board has discussed how to display gains and losses from actuarial changes on the financial statements, especially the statement of net cost (SNC). The display issue arose in the context of social insurance but involves other agencies as well.

Statement of Net Cost – The statement of net cost shall display, as separate components of operating cost allocated to programs, line items for:

1. the change in the present value attributable to increasing benefits from the beginning to the end of the reporting period, and
2. interest on the obligation for the current year shall be displayed

Actuarial gains or losses and prior service costs, if any, shall be presented as separate, non-operating costs that are part of the total cost on the statement of net cost.

Balance Sheet – The balance sheet shall display one line item for the liability.

6. Appendix A: Basis for Conclusions
7. Appendix B: Pro forma illustrations
8. Appendix C: Glossary

[3] SFFAS 25, par. 31.

DEPARTMENT OF VETERANS AFFAIRS
Veterans Benefits Administration
Washington DC 20420

In Reply Refer To:

Accounting and Auditing Policy Committee
c/o Federal Accounting Standards Advisory Board
Attention: Wendy Comes, Executive Director
441 G Street, NW
Room 6814, Mail Stop 6K17V
Washington, DC 20548

Dear Ms. Comes:

I am requesting that the Accounting and Auditing Policy Committee provide guidance for the interest rates used for the Department of Veterans Affairs' (VA) Future Liabilities Projection for the Compensation and Pension program. As required by Federal Financial Accounting Standards Number 5, Accounting for Liabilities of the Federal Government, the VA's future liabilities is discounted at a Treasury borrowing rate. The VA currently uses a one-day US Treasury spot rate.

As a result, the future liabilities projection, which is over $1 trillion, is susceptible to more volatility than alternative discounting measures. The VA has been criticized by the Office of Management and Budget and the Department of Treasury for the extreme changes in our future liabilities projection as a result of using the spot rate. Consequently, I believe there may be alternative options that would mitigate the impact of the one-day US Treasury spot rate while also meeting the intent of Federal Financial Accounting Standard 5.

Along with the Discount Rate submission, I have included a discount discussion paper from our actuary for further guidance.

If you have any questions regarding this matter, please contact Mitch Sturm, Director of Financial Services, at (202) 273-6728.

Sincerely,

James W. Bohmbach
Chief Financial Officer

Enclosures

TITLE.

The Discount rate assumption used to estimate the present value of benefit payments for the future liabilities projection of the Department of Veterans Affair's Compensation and Pension Programs.

ISSUE.

Should the discount rates be based on a single day's interest rates or an alternate set of interest rates, such as an average of interest rates over a period of time?

The VA currently estimates its liability for veterans' Compensation and Pension benefits and related administrative expenses using a discounted cash flow model. The present value of future benefit payments are discounted using the U.S. Treasury spot rates as of September 30 for the fiscal year.

Changes in these interest rates from year to year have caused large fluctuations in the Compensation liability, creating confusion among U.S. government financial statement users. For example, the following table shows the changes in the liability for the Compensation program during the last four fiscal years due solely to the difference in discount rates:

Fiscal Year	Change in Liability Due to Change in Discount Rates
2002	$ + 108.1 billion
2003	- 29.0 billion
2004	- 44.7 billion
2005	+ 106.5 billion

Representatives of the Office of Management and Budget and the Department of Treasury recently expressed concern over the large impact on the consolidated financial statements of the Federal Government caused by the differences in discount rates.

As further background to this issue the accompanying memorandum entitled "Discussion Paper on Discounting of Liability", dated March 6, 2006 authored by Sam Gutterman of PricewaterhouseCoopers, describes historical current practice and several possible alternative approaches.

RELEVANT LITERATURE.

The Statement of Federal Financial Accounting Standards Number 5, Accounting for Liabilities of the Federal Government, paragraphs 95 and 96, specifically identifies veterans' disability payments as an Other Post Employment Benefit (OPEB) and states that long-term OPEB liabilities should be measured at the present value of future payments. As stated in paragraph 95, the payments should be discounted at the Treasury Borrowing rate for securities of similar maturity to the period over which payments are to be made.

OPTIONS.

The following options would provide a more soundly-based representation of the long-term interest rates that might be used as a set of discount rates, while at the same time decrease the volatility of interest rates compared with the current practice of using discount rates based on observed values from the capital markets as of a single day rate.

- An average yield curve over a specified period of time, such as the prior one month, quarter, five years or longer. This would tend to stabilize the estimate, as daily fluctuations would not have as significant of an effect as that of a single day.

- Estimated long-term average interest rates, possibly using historical averages over a long period, at least over an entire business cycle.

- Longer-term interest rate expectations reflecting actuarial judgment in assigning discount rates, as currently used by the Social Security and Medicare Statement of Social Insurance and many private pension plans.

OTHER ENTITIES.

The VA's Future Liabilities Projection is unique from other agencies, because of the unfunded liability's sizable amount. Changes in this liability have a significant effect on the consolidated financial statements of the U.S. Federal government.

POINT OF CONTACT.

Please contact James Bohmbach, CFO of Veterans Benefits Administration, at (202) 273-6728.

Tab I-4, Outline and Issues Related to a Separate Exposure Draft Dealing with Actuarial Issues, Appendix A – VA Letter and FASAB Staff Response

Statement of Issue

The obligation of the Department of Veterans Affairs (VA) with respect to its Compensation and Pension programs consists of benefit payments to veterans who satisfy certain conditions and their survivors and dependents, together with corresponding administrative expenses. These benefits can occur in extreme cases more than one hundred years after military service occurs (e.g., there are still beneficiaries being paid relative to service in the Civil War).

The estimate of the liability associated with these obligations is currently determined in the following manner:

- Compensation – the present value at the valuation date of future Compensation benefit payments and associated administrative expenses.

- Pension program – the amount due and payable at the valuation date, although in addition the VA discloses the amount derived from the same method as is used for Compensation.

To determine the present value of these benefit payments and expenses (cash flows), it is necessary to discount them to the applicable valuation date. This paper describes the methodology used to determine these discount rates and some of the possible alternatives that have been discussed.

Due to the method currently used to discount these future cash flows, significant fluctuations in the value of this liability have occurred over the last twelve years. These fluctuations have had a noticeable affect on the financial statements of the U.S. government. The extent of these fluctuations has been discussed from time to time by various elements of the U.S. government.

Historical Approaches Used

The current discounting methodology, with several relatively minor exceptions, has been in place for the last twelve years. The discount rates used in the calculation of the present value of benefits and administrative expenses have been based on relevant interest rate yield curve at the date of the valuation. Several justifications have been used for this approach, including the following:

- Since there is no fund or assets accumulated to provide for these benefits, the discount rates should be based on the current cost of funds of the U.S. government that provides the "guarantee" for and are matched with the durations of the expected benefit payments and that provides for the associated administrative expenses.

- The present value represents the fair value of the liability, with the discount rates being the risk-free rates corresponding to the expected timing of future benefit payments that would be used if the obligation was traded on a market at the valuation date.

- The Compensation program is considered by FASAB to be an "other post-employment benefit" (OPEB), whose benefit payments should be discounted at a set of interest rates that match the payments' expected timing.

The current methodology uses the following assumptions, with previous variations identified where applicable:

1. Benefit payments are made at the end of each month and administrative expenses are payable in the middle of each month (prior to September 2005 it was assumed that all benefit payments were made in the middle of each year).

2. Each year's expected benefit payments are discounted separately, using current (as of the last day of financial market trading of each fiscal quarter) spot rates for U.S. Treasury securities for key durations (1, 2, 3, 5, 7, 10, 20 and 30 (or the last duration of securities available to be traded)), and interpolated between these durations where appropriate. This contrasts with the assumption used prior to September 2004, which used constant maturity rates (as published in the monthly Federal Reserve Statistical Releases) for these same traded securities instead of their spot rates; this change was made to better match the timing of the interest rates to the expected benefit payments.

3. The spot rate applied to all benefits expected to be payable more than thirty years in the future is the spot rate for the longest dated U.S. Treasury securities that are publicly traded.

4. The duration of discount corresponds to the time between the valuation date and the average time that the expected benefits and administrative expenses are paid, separately for each cohort of expected benefit payments.

Although benefits are assumed to be payable at the end of each month, since U.S. Treasury securities are not auctioned every month, exact yield curves are not available. The discount rates applied have been derived through an interpolation process. For cash flows expected to occur more than thirty years after the valuation date, the yield rate for corresponding thirty year U.S. Treasury bonds was used.

U.S. Government Securities – Constant Maturities

End of Month	6 Month	1 Year	2 Year	3 Year	5 Year	7 Year	10 Year	20 Year	30 Year
Sep-95	-	5.69%	5.89%	5.97%	6.08%	6.20%	6.26%	6.70%	6.57%
Sep-96	-	5.71%	6.10%	6.28%	6.46%	6.60%	6.72%	7.05%	6.93%
Sep-97	5.28%	5.47%	5.80%	5.88%	6.00%	6.11%	6.12%	6.47%	6.41%
Sep-98	4.49%	4.41%	4.30%	4.26%	4.23%	4.38%	4.44%	5.17%	4.98%
Sep-99	4.99%	5.22%	5.63%	5.70%	5.78%	6.10%	5.90%	6.47%	6.06%
Sep-00	6.28%	6.07%	5.98%	5.91%	5.85%	5.93%	5.80%	6.13%	5.88%
Sep-01	2.36%	2.49%	2.87%	3.22%	3.39%	4.37%	4.60%	5.45%	5.42%
Sep-02	1.51%	1.53%	1.72%	2.02%	2.63%	3.25%	3.63%	4.75%	4.80%*
Sep-03	1.01%	1.15%	1.50%	1.95%	2.85%	3.41%	3.96%	4.91%	4.97%*
Sep-04	2.00%	2.21%	2.63%	2.89%	3.38%	3.79%	4.14%	4.89%	4.97%*
Sep-05	3.93%	4.01%	4.18%	4.18%	4.18%	4.23%	4.34%	4.62%	4.53%*

*30 year U.S. Treasury securities were not offered at that time; rate is for 26-29 year maturities

Spot rates do not precisely correspond with the above rates, but they are quite similar. As can be seen, considerable volatility in interest rates at various year-ends has occurred. Similar volatility has occurred for spot

rates and over quarterly intervals. Note that because of the long-term nature of the benefits involved, the most important interest rates to focus on are those between ten and thirty years.

Applicable FASAB Standards

The Financial Accounting Standards Advisory Board (FASAB)'s Statement of Federal Financial Accounting Standards (SFFAS) Number 5 ("Accounting for Liabilities of the Federal Government") is the guiding accounting standard relevant to assessing the appropriate discount rates for U.S. government liabilities. Note that when FASAB statements do not address a particular accounting issue, FASB statements or GAO rules may apply.

According to SFFAS 5, Appendix B, the VA's Compensation program has been classified as an OPEB program while the VA's Pension program has been classified as welfare program, financed by general revenues on a pay-as-you go basis. The liability for Compensation is "the present value of future payments due", while the liability for Pension is the amount due as of the reporting date. Nevertheless, the liability for the Pension program has been estimated in the past in a manner similar to that of the Compensation program and disclosed accordingly. Note that, although the criteria for obtaining benefits differ, the fundamental obligations under these programs do not appear to be materially different.

SFFAS Number 5 indicates several possible methods for discounting, depending upon the type of government program involved:

1. Pension plans. Paragraph 159 indicates that for Pension plans "the discount rate should reflect the long-term expected return on plan assets rather than a current market rate on debt of comparable maturity (the discount rate called for by SFAS 87). The long-term expected rate can reduce volatility, reflects the actual expected asset earning rate and expectations of the federal plans, and is consistent with the assumptions used in the budget." However, neither the Compensation nor the VA's Pension program is classified as a pension plan. As a result, this approach may not be applicable.

2. Other retirement benefits. Paragraph 83 indicates that for "other retirement benefits", the discount "rate used to discount projected benefits should be equal to the long-term expected return on plan assets if the plan is being funded or on other long-term assumptions (for example, the long-term federal government borrowing rate) for unfunded plans. The administrative entity should disclose the assumptions used". However, neither the Compensation nor the Pension program is truly a retirement plan. As a result, this approach may not be applicable either.

3. Other Post employment Benefits (OPEB, including health care benefits). If categorized as an OPEB, paragraph 95 indicates that "a long-term OPEB liability should be measured at the present value of future payments. This will require the employer entities to estimate the amount and timing of future payments, and to discount the future outflow using the Treasury borrowing rate for securities of similar maturity to the period over which the payments are to be made." Since direct reference to "veterans' disability compensation" is made in paragraph 96, it appears that "the Treasury borrowing rate for securities of similar maturity" would be the most appropriate approach to use. However, note that paragraphs 95 and 96 do not specify which Treasury borrowing rate to use.

4. Welfare programs. According to FASAB, liabilities for welfare programs do not include future benefit payments except to the extent that they are currently due and payable. As a result, no discount rates would be applicable.

Tab I-4, Outline and Issues Related to a Separate Exposure Draft Dealing with Actuarial Issues, Appendix A – VA Letter and FASAB Staff Response

Impact of the Use of Current Treasury Borrowing Rate

To provide a context regarding the impact of discount rates, the following are estimates of the effect of the change in discount rates over the last several years if the liability of all three VA programs had been determined on the basis of the present value of these benefit payments (excluding administrative expenses):

Changes in the annual present value of future benefits in the fiscal year solely due to the changes in discount rates (in $billions)

Fiscal year	Compensation	Pension	Burial	Total
2002	$ + 108.1	$ + 11.7	$ + 0.4	$ + 120.2
2003	- 29.0	- 3.1	- 0.1	- 32.2
2004	- 44.7	- 5.2	- 0.1	- 50.1
2005	+ 106.5	+ 9.3	- 0.0	+ 116.6

As demonstrated by the above, changes in discount rates have had a significant affect on both the VA's standalone and the U.S. government financial statement during the last several fiscal years. Relatively large changes in the liability for these programs would have resulted from the application of any market value based valuation methodology, because no existing assets are held to stabilize such values.

At September 30, 2005, a sensitivity test was conducted of the liability for future benefit payments using the spot rates as of that date. For example, for Compensation the liability would decrease by about $193 billion (17.3% of the liability) or increase by about $267 billion (24.0% of the liability).

To summarize, the use of the current discounting methodology based on the period ending yield curve in a year that long-term interest rates changes occur will result in significant fluctuations in estimated liabilities for these programs.

Alternative Approaches to Issues Associated with Discount Rates

The issue of volatility of the liabilities of these programs has been raised several times over the years. This and related issues related to volatility can be assessed in the following three categories:

1. Limited time between the valuation date (September 30 for annual financial statements or end of quarter for interim financial statements) and mid-October, when the draft actuarial memo has been requested. The current method uses the U.S. Treasury yield curve as observed through trades of these securities on the most recent day in which financial markets are open prior to the valuation date provides less than two weeks to develop an estimate of the liability and a draft set of documentation. Note that it is acceptable for the purposes of the Statement of Social Insurance for social insurance programs such as Social Security and Medicare to measure their value at any time within twelve months prior to the valuation date, currently anticipated to be as of the prior December 31, although the calculations are not quite comparable as these programs do not use a current yield curve. Possible approaches to address this practical calculation challenge include:

    a. Use the market-based yield curve as of a single day somewhat prior to the valuation date, such as August 30 or September 15. Although this reduces the calculation challenge, it does not address the volatility concern, as it still involves a single day's yield curve.

    b. Use an average yield curve over a specified period of time, such as the prior one month, one quarter, five years or longer. This would likely stabilize the estimate somewhat, as daily fluctuations would not have as significant effect as that of a single day.

    c. Use actuarial judgment based on expectations of longer term interest rate expectations, as currently

used by the Social Security and Medicare Statement of Social Insurance and many private pension plans.

2. Significant volatility caused by the use of a current yield curve. These include at least the following partial solutions:

    a. Use an "average" yield curve over a recent period, such as the average daily rate for the prior month, quarter, five year or longer period prior to the valuation date. The longer the period, the more stable the resulting discount rates tend to be, while at the same time the longer the averaging period the farther removed from being characterized as being current rates.

    b. Use estimated long-term average interest rates, possibly using historical averages over a long period of time covering at least an entire business cycle.

    c. Use actuarial judgment, the latter being used currently in many private and government pension plans and Social Security.

3. Other approaches that might address the volatility issue include.

    a. Reinterpret or revise paragraphs 95 and 96 of SFFAS 5 to enable the use of something other than interest rates of the end of the fiscal period.

    b. Revise SFFAS 5 to re-classify the Compensation and/or Pension programs to enable the use of a longer term or average discount rate methodology. It is not known whether FASAB realized when SFFAS 5 was adopted the potential for size of the volatility of the liability.

    c. Estimate COLAs so that they vary in a manner consistent with the current yield curve. The volatility indicated above in part has arisen because the effect of changes in the market yield curve has been inconsistent with the effect of OMB's semi-annual COLA estimates. If they moved in the same direction, their combined effect would partially offset each other. Possible approaches that could be further researched include the incorporation of the COLA assumption the implied inflation rates derived from TIP prices, us of more frequent, timely or relevant OMB estimates, or use of estimated real interest rates combined with no COLA projections. Particularly at longer periods, net real interest rates (nominal interest rates minus corresponding inflation estimates) using an assumed relationship would reduce the volatility.

    d. For Compensation, use market consistent disability rates. One example of this approach is used by the Pension Benefit Guaranty Corporation (PBGC) in its attempt to reflect the value that the private insurance market would place on a certain portion of their liability. One basis of their valuation is to estimate what a typical commercial insurer would charge to take over or buy all or parts of the C&P obligations. Theoretically, commercial insurers might be asked to price a subset of the future Compensation benefit payments as of the valuation date, the price for which might serve as a base from which to estimate the present value of the program's expected future benefit payments on a market consistent basis. Note that it is not certain that this would reduce the volatility.

    e. Use an average current cost of capital of the U.S. government as if it was funding these obligations through issuance of U.S. Treasury securities. This could be represented by a blended rate based on some form of weighted average of various durations of U.S. Treasury securities.

    f. Although likely to be an unacceptable change, begin funding these programs, possibly enabling the use of longer term interest rate averages or having changes in asset values offset in part corresponding changes in discount rates used. This drastic policy change would constitute a significant change in government funding of these VA programs.

Tab I-4, Outline and Issues Related to a Separate Exposure Draft Dealing with Actuarial Issues, Appendix A – VA Letter and FASAB Staff Response

Summary

Three issues are discussed above: (1) the short time period available to produce an estimate as of a valuation date, (2) reliance on current yield curve as of a single date, and (3) additional approaches that might address the volatility issue described above. Several of these may be inconsistent with acceptable interpretations and applications of SSFAS Number 5 or are unacceptable for other reasons.

Although the current approach (use of discount rates based on the spot yield curve in effect on the valuation date for VA's Compensation program) have been deemed to be consistent with the above interpretation of SFFAS Number 5, resultant values have been subject to significant recent volatility over the last several years. This discussion paper has briefly discussed several alternatives that might be considered. It is recommended that these issues continue to be evaluated.

Sam Gutterman

PricewaterhouseCoopers LLP

March 6, 2006

Tab I-4, Outline and Issues Related to a Separate Exposure Draft Dealing with Actuarial Issues, Appendix A – VA Letter and FASAB Staff Response

April 20, 2006

James W. Bohmbach
Department of Veterans Affairs
Washington, DC 20420

Dear Mr. Bohmbach,

I am writing in response to your letter requesting that the Accounting and Auditing Policy Committee provide interest rate guidance for the Department of Veterans Affairs' (VA) use when calculating the present value of liabilities. I have forwarded your request to the AAPC. However, I have recommended that the AAPC take no action at this time because the FASAB currently has a project on its agenda addressing actuarial issues. The Board is currently reconsidering the accounting treatment for social insurance. Actuarial assumptions, and the gains and losses generated by changes therein, are critical for social insurance.

In addition to an imminent exposure draft on social insurance, the Board is planning to issue an additional exposure draft on actuarial issues that will be larger in scope than just social insurance. The Board has discussed how to display gains and losses from actuarial changes on the financial statements, especially the statement of net cost (SNC). The display issue arose in the context of social insurance but involves other agencies as well. As your letter demonstrates, the largest items on the operating statement for the Financial Report of the United States Government and on the SNC for the component entities involved are the changes in actuarial estimates.

There are significant actuarial issues in addition to display to be considered. For example, in the past the Board has provided, as you know, very general standards with respect to discount rates and other assumptions. The actuarial project will afford an opportunity to retain that approach or to be more specific. Also, heretofore the Board has preferred to emphasize, in SFFAS 5 and SFFAS 17 and elsewhere in its guidance regarding actuarial assumptions, long-term trends rather than short-term effects. The new project will afford an opportunity for the Board to re-affirm – or change – that preference. And there may be other issues as well.

Regarding guidance for VA while the actuarial standard is developed, a fair reading of the standards leads to three conclusions. First, the OPEB standards provide guidance for long-range actuarial projections but so, too, do the pension and post-employment healthcare standards. Second, actuaries should use their best estimate assumptions to calculate the pension expense and liability. And, third, the emphasis should be on long-term trends rather than short-term effects. The OPEB standard, SFFAS 5, par. 95, which requires employer entities to estimate the amount and timing of future payments using the Treasury borrowing rate for securities of similar maturity to the period over which the payments are to be made, could support the approach VA has taken. However, the pension standard SFFAS 5, par. 65, also emphasizes expected long-term future trends rather than giving undue weight to recent past experience; and par. 66 requires long-term assumptions and gives the example of the long-term federal government borrowing rate. This could reasonably support an interest rate that weighs interest rate experience more heavily than spot rates. Thus, staff believes that each of the three options you identified is permissible under SFFAS 5.

As the actuarial standard is developed in the near future we are hopeful that the VA and other agencies involved will respond positively to the requests we will make for their technical expertise and comments on our accounting proposals. Should you have any questions, suggestions, etc., the project manager for the actuarial project (and social insurance) is Richard Fontenrose (202) 512-7358, fontenroser@fasab.gov.

I must add a caveat: the guidance in this letter is non-authoritative and does not constitute Federal generally accepted accounting principles (GAAP).

Best regards,

Wendy Comes
Executive Director
Federal Accounting Standards Advisory Board